

Project Manager
Energy market investigation
Competition and Markets Authority
Victoria House
Southampton Row
London
WC1B 4AD

Competition and Markets Authority: Energy Market Inquiry – Statement of Issues, 24 July 2014

Submission by Paul Hunt¹, 13 August 2014

Email: paulhunt@btinternet.com

Introduction

1. The opportunity to submit observations on this Issues Statement is very welcome. This document highlights the erosion of citizens' trust not only in the energy suppliers, but in all other agencies participating in the energy sector. It examines the issues and areas this market inquiry might investigate so that it and its findings will be able to contribute to the restoration of public trust and confidence.

The erosion of citizens' trust as both energy consumers and taxpayers

2. The Members of the CMA Panel selected to conduct this Energy Market Inquiry refer to the "notable lack of trust between operators and customers" (Para. 9) and to the need "to restore the confidence of both customers and investors" (Para. 10). This

¹ Paul Hunt is an independent energy economics consultant working primarily in the areas of gas industry structure and regulation with a specific interest in the development, financing and pricing of services on gas transmission and distribution networks. He has also applied the common principles and procedures of the financial and economic analysis of investment in specific, long-lived assets to assignments in the oil and electricity industries, since these industries are also characterized by this type of asset.

Beginning with significant involvement in gas market liberalisation in Great Britain – including advising the gas regulator and the then Monopolies and Mergers Commission (subsequently re-configured, via the Competition Commission, as the Competition & Markets Authority) - the geographical scope of his work has expanded and he has considerable international experience throughout Europe, Africa, the Middle East, Russia and East Asia. He has provided advice to the European Commission on its gas market liberalization programme and evaluated gas interconnection and storage projects under the European Energy Programme for Recovery. He has worked for gas market participants throughout the EU in the context of gas market liberalization and is involved in the development of the EU's Gas Target Model being facilitated by the Directorate-General for Energy of the European Commission (DG ENER), the grouping of national energy regulators for the Member States (ERGEG) and the Agency for Cooperation of Energy Regulators (ACER). He has written a paper which sets out a basis for developing the mandated Entry-Exit pricing of gas transmission in the context of the EU Gas Target Model:

<http://www.oxfordenergy.org/wpcms/wp-content/uploads/2010/11/NG23-Entry-ExitTransmissionPricingwithNotionalHubsCanItDeliverAPanEuropeanWholesaleMarketInGas-PaulHunt-2008.pdf>

lack of trust may be more widespread and deep-seated than the Members recognise. There is more than anecdotal evidence that many citizens and residents not only as energy consumers but also as taxpayers and voters are becoming increasingly disgusted and angry with the antics both of electricity and gas suppliers and of governing politicians, policy-makers and regulators who have energy sector responsibilities. The closeness of government and the industry (with industry staff being seconded to work in the Department for Energy and Climate Change (DECC)), the perception that the industry is able to apply intensive lobbying and other influence over governing politicians, policy-makers and regulators to secure preferential treatment at the expense of their customers and the apparent 'revolving door' between government (in its broad political, policy and regulatory sense) and the industries all fuel this increasing anger and disgust. And this increasing anger and disgust is compounded by the fact that most citizens and residents find it very difficult to secure knowledge and information about the energy industry they can trust and which they require to make informed decisions.

The erosion of trust in the energy companies

3. It is not surprising that many have largely given up on the energy companies. They have no shortage of evidence that the possibility or risk advanced by the Chairman of the CMA, highlighted in the Currie Lecture earlier this year, of competition taking a malign form, "with businesses competing to gouge, rather than serve, customers" has become the pervasive reality in the energy sector.² The behaviour of the energy companies is perfectly rational. It is not possible for them to compete by offering clearly differentiable service offers; the same electricity is delivered at the meter-points of households and businesses irrespective of who their supplier is. These firms can't offer services that match the consumption patterns of households and of most businesses or provide a service that rewards them for altering their consumption patterns in ways that will reduce the cost of supply both for the suppliers and for them. Quite simply, the suppliers can't sell what they can't measure and this has been the fundamental problem with full retail competition in both electricity and gas since it was rolled out in 1998.
4. So it should not be surprising that they compete furiously on price and, via a plethora of tariffing options and other frequently less savoury, if not unethical or illegal, techniques, seek to entice, ensnare and then gouge their customers. At the same time they are prepared to 'churn' the relatively small proportion of customers who are price-sensitive and active and who switch between suppliers. These firms are able to concentrate considerable resources on their targets – energy consumers.
5. In contrast, energy consumers are atomised, individualised and disenfranchised. Though they might have grumbled about the service at the time, many older consumers retain a sense of the benefits of being customers, collectively, of publicly owned regional electricity and gas businesses. Younger consumers, however, lack this frame of reference. But most energy consumers, both young and old, have neither the time nor the resources to engage effectively with the suppliers. The opportunity cost is simply too high in terms of time, effort and how such activity interferes with or impacts on activities that they consider far more important or value more highly. A number may not have internet access – which is increasingly the most common means of communicating with these firms (and which the firms encourage) – but those who attempt to engage with the energy suppliers, either via the internet or via operators in call centres (which may be anywhere in Britain, if not

² Lord Currie, "The case for the British model of independent regulation 30 years on", Currie Lecture given to the Cass Business School, London, 21 May 2014: <https://www.gov.uk/government/speeches/the-case-for-the-british-model-of-independent-regulation-30-years-on>

anywhere on the planet) find the experience extremely frustrating. All they are seeking is to secure an affordable and reliable electricity and gas utility service; most are well aware that the suppliers cannot offer a service that might match their actual or preferred consumption patterns. Pursuing this simple objective can prove to be a life-sapping experience.

6. In this context, it is interesting to note that retail supply to larger businesses was excluded from the reference (Para 11). These larger firms tend to have dedicated competent staff responsible for purchasing goods and services. Many will have dedicated competent staff responsible specifically for energy purchasing or, if the volumes of energy consumed are sufficiently large, for direct participation in the energy market. These may be viewed as sophisticated buyers and market participants. It would be both difficult and unwise for the energy suppliers to attempt to gouge these consumers in the same way that they gouge households and smaller businesses.
7. In the light of all of this it is depressing to find that many governing politicians, policy-makers and regulators (as well as energy sector commentators) frequently blame consumers for not being sufficiently active in the market to impose the necessary competitive pressures on the energy suppliers. Given the commercial objectives of the energy suppliers, the suppliers' behaviour they confront and the suppliers' inability to offer services that match their actual or preferred consumption patterns, the behaviour of the majority of energy consumers who are deemed to be insufficiently active may be perfectly rational.
8. The Members' intention to investigate the apparent inactivity of so many energy consumers and the impact this may have (Theory of Harm 4, Hypothesis 4a, Paras. 50ff) is welcome, but, unfortunately it is couched in the pejorative terms so frequently used by governing politicians, policy-makers and regulators. It is to be hoped that the Members will extend their investigation to address the issues raised above, because the behaviour of so many consumers appears to be perfectly explicable and rational, even if the outcome is detrimental to their interests. It may be that no remedies are immediately available and that the roll-out of smart meters to all consumers (Para. 18, 1st bullet point) may provide the best and only means for suppliers to make clearly differentiable service offers that will properly engage energy consumers and allow them to exert the necessary competitive pressure on suppliers.

The erosion of trust in other agencies

9. However, the erosion of trust goes deeper and wider. In addition to their well-justified contempt for the energy companies, many consumers, in equal measure, ignore and are disgusted by the web of lies, half-truths and fictions that governments of all stripes spin. Furthermore, almost everyone they encounter with some knowledge of, or competence in, the industry is constrained, compromised or conflicted in some way or is pursuing some agenda or other. The energy companies and the government (in all of its manifestations) are the principal sources of funding for academics and are among the principal sources of fee-paid work and consulting, accounting, PR, legal and advisory firms and revenue-generators for all other providers of services and equipment. It would not pay for them to bite the hands that feed them.
10. Recent changes in the consumer protection 'landscape' have emasculated the statutory consumer protection bodies. They are either unable or unwilling to advance and protect the collective interests of energy consumers. And, as statutory agencies, they are bound and constrained by the overall thrust of government policy. The voluntary consumer protection associations generate sound and fury, but little substance. The media, in most instances, either lack resources or are too lazy to get to grips with the complexity of energy policy and regulation and to communicate this

to their listeners, viewers or readers. Advertising revenues may also have an impact on editorial stances and the allocation of resources.

Restoring trust and confidence

11. It is entirely laudable for the Members to envisage that this inquiry and its findings might begin to restore consumer trust and the confidence of both consumers' and investors' confidence in the market. But, in two major respects, the approach outlined by the Members raises doubt that this desirable outcome will be achieved.

A reliance on the application of mainstream neoclassical economics

12. In some respects it is reassuring to find (Para. 17) that the 'benchmark' the Members propose to use when investigating the possible existence of an effect against competition (EAC) is that of a 'well-functioning market' – and that this benchmark will not be based on an idealised or theoretical notion of a perfect market. But all of the indications are that any analysis that will be performed will be based on a modern application of the methods and techniques of mainstream neoclassical economics. Despite the expansive and innovative development and application of techniques within this canon and the continuing adherence of the majority of practitioners of economics, this reliance is unlikely to contribute to the restoration of trust and confidence desired by the Members.
13. Thus is for two reasons. First, the development and application of mainstream neoclassical economics to the financial sector contributed significantly, from the early 1990s, to the dismantling of long-standing regulation of the financial sector in a number of the advanced economies, to the financialisation of economies and a massive expansion of credit and leverage and to the proliferation of little-understood, and deliberately under-regulated, markets in derivative instruments. These, in turn, led to the collapse of some banks from 2007, leading to the 'credit-crunch' in late 2008 which triggered the Great Recession and from which most advanced economies have yet to recover. Many leading mainstream economics practitioners were cheer-leaders for these developments; many more proved to be 'useful idiots' for industry participants, policy-makers and regulators whose behaviour triggered the various crises. While there has been a concerted, if disingenuous, effort to quarantine the failed applications of neoclassical economics in the financial sector and to limit, if not to deny, contamination of other sectors of the economy, only the wilfully blind would contend that no contamination has taken place. The application of economic analysis to the energy sector in this inquiry will not only have to be uncontaminated by these failings, but it will have to be seen to be uncontaminated. It will take a long time to change the public perception that much economic analysis is conducted to serve the interests of the powerful, wealthy and influential – and, by default, is damaging to the public interest. The Members, perhaps, might find it worthwhile to bear this in mind.

A potential failure to take full account of the institutional context and political economy of the energy sector

14. The second reason is more profound and multi-faceted.

The impacts of climate change policies

15. It is perfectly legitimate for the Members (in Para. 20) to declare that "overarching government targets and objectives (such as targets for emissions reductions) will be treated as context for our investigation" and that "[i]t is not for the CMA to take a view on the costs and benefits of such targets for energy customers". Leaving the option open that the Members may review the design of certain policies that have been put in place to meet these targets is better than closing out this option, but there is a strong case for suggesting that the Members should be more definitive. There is

considerable evidence that the mix of policies being implemented in the energy sector is adding greatly to the costs being incurred by energy consumers and taxpayers while little progress is being made to achieve the policy objectives. And there is a widespread public perception that this is the case.

16. For example, the avoidance of the emission of a tonne of CO₂ has the same societal value wherever on the planet its emission is avoided. It is clear that the Government may directly influence or control emissions only within its jurisdiction, but those who avoid the emission of a tonne of CO₂ by generating electricity from renewable sources are being rewarded handsomely (and possibly excessively) by energy consumers and taxpayers, while those who could avoid the emission of the same tonne at considerably less cost and far more efficiently, by displacing coal-fired generation with gas-fired generation, are being penalised – and are being penalised almost to the point of severe financial hardship or bankruptcy in some instances.
17. There are numerous examples of such market-distorting impacts arising from the design and implementation of climate change policies. Even a well-functioning market would suffer from such impacts; it would be surprising if one that is subject to investigation because there is a prima facie case for the existence of some dysfunction were not suffering even more. The Members, when they have considered the available evidence, are uniquely empowered and equipped to say to government: “Perhaps, you should think again.”

The EU dimension

18. It is somewhat baffling that a statement of the issues that will be investigated in a comprehensive inquiry in to the electricity and gas markets in Great Britain makes no mention of the EU, of its institutions, of the primary energy sector (and climate change) legislation these institutions have enacted (which are binding on Great Britain), or of the progress being made to implement EU-wide Electricity and Gas Target Models. It may be that the Members (similarly, apparently, to some former regulators) are proud that the British model of energy sector competition and regulation has been adopted and adapted in various ways throughout the EU and that the impacts and effects are all one-way.
19. The reality, however, is that both well-functioning and dysfunctional features of this British model have been adopted and adapted throughout the EU and both the primacy of EU legislation and increased integration of electricity and gas markets means that the markets in Britain are subject to impacts of some of these features. Since the Members assert that they propose to adopt a forward-thinking stance (Para. 18), it would probably make sense to consider likely impacts, both beneficial and detrimental, of further integration of the EU’s electricity and gas markets.
20. There is a further EU dimension which the Members appear to have neglected. Four of the so-called Big 6 energy suppliers are subsidiaries of four of the EU’s Big 7 integrated energy companies. Their parents’ balance sheets have taken a pounding over the last number of years for a variety of reasons. These include the impact of the Great Recession, a lack of strategic foresight, more rapid penetration of renewable electricity generation than was expected, the displacement of gas-fired generation both by renewables and coal – the latter mainly due to coal being displaced by gas in electricity generation in the US – and, in Germany, the phasing out of nuclear generation by 2022. There is a public perception that these subsidiaries of the EU’s Big 7 operating in Britain have been milking British energy consumers to help shore up their parents’ balance sheets. It is a further issue that is probably worthy of investigation.

The behaviour and perceptions of equity investors

21. In the context of Britain's privatised utility firms, Helm and Tindall³ document the significant changes of ownership that shifted from the initial focus on dispersed retail share ownership through takeover and mergers to more concentrated ownership and the more recent emergence of private equity and infrastructure funds. The authors show how regulation has determined the allocation of risk and has facilitated the observed changes in ownership and financial structures. A very significant finding is that these changes in ownership structure have been both accompanied and effected by substantial financial engineering – generally incentivised by arbitrage between the marginal cost of debt and the regulated Weighted Average Costs of Capital (WACC) - and balance sheets have been geared up towards exhaustion – with major implications for financing future investment.
22. This assessment adds to the evidence that many investors focus on a short-term maximisation of the post-tax return on equity and on capital appreciation. This focus discourages investment in the long-lived, specific assets that characterise the energy industry. As a result, investment is not forthcoming unless investors can secure their desired returns either directly from regulators, in the case, of regulated activities, or from participation in the market, in the case of unregulated activities. The result is that, in addition to fairly steady increases in wholesale gas prices from 2009 until the start of this year, final prices have been ramped up in this period by investors seeking higher returns for investing in non-regulated activities and by the regulator being compelled to award returns far higher than they should be. Whether or not the Members view this as a possible effect against competition, it has had a significant impact on final prices and has contributed to growing public discontent.

The potential for expanded competition and better consumer protection

23. It is generally accepted that the wholesale gas market functions well in the US. It is in fact a combination of markets with deep and liquid spot, forward and futures markets in the gas commodity and an equally deep and liquid market in gas pipeline capacity. This well-functioning market permits a balance to be sustained between the interests of consumers and investors and benefits both.
24. However, it appears to be equally accepted, particularly by those on this side of the Atlantic, that it is impossible to replicate the functioning of the US gas wholesale market in the EU. A variety of political, administrative, institutional, economic and technical differences are advanced to justify this contention. Most of these differences are more apparent than real and the reasons that are advanced are often specious and self-serving. It should not be surprising to find that those enjoying granted monopoly rights or exercising market power are adamantly opposed to any changes that might diminish their enjoyment of these rights or their exercise of this power.
25. It is a little worrying (Para. 16, 2nd bullet point) that the Members appear to have swallowed this largely self-serving 'conventional wisdom' that electricity and gas networks are natural monopolies. It is certainly possible to make the case that electricity transmission and electricity and gas distribution should be treated as natural monopolies within defined geographical areas, but there is no technical or economic rationale to define gas transmission pipelines as natural monopolies.
26. In relation to the apparent failure of the current institutional arrangements to advocate and protect the collective interests of final energy consumers, there may be some value in examining how the 'remunicipalisation' of energy supply in Germany (and

³ Helm, D.R. and Tindall, T. (2009) 'The evolution of infrastructure and utility ownership and its implications', *Oxford Review of Economic Policy*, 25 (3), 411-434.

elsewhere in the EU) benefits final consumers and whether or not there are lessons for Britain. These again should present areas worthy of investigation by the Members.

A comparative view of the electricity market in Great Britain

27. Much attention is paid to the data on household and industry electricity and gas prices collected and published by Eurostat. Even though electricity prices to households in Britain have increased in the last five years and this has contributed to the public discontent (which has been exploited politically), they remain comfortably in the middle of the ranking of prices to households for all EU member-states. Prices in Ireland, however, are near the top of the ranking and have been there for some time. Not surprisingly, this attracts public attention in Ireland and various official bodies – and researchers affiliated to or sponsored by these bodies – expend considerable effort seeking to explain, and to explain away, the differences between prices in Ireland and those in other member-states. Again, not surprisingly, comparisons between prices in Ireland and in Britain attract quite a deal of attention. Some recent research by Deane et al is relevant in this respect.⁴ The findings of the authors are worth quoting:

“Our findings strongly suggest that the wholesale price in Great Britain (GB) is much lower than in Ireland. We argue that the difference between wholesale prices in SEM (the Irish Single Electricity Market) and BETTA (British Electricity Transmission and Trading Arrangements) is not driven by technological factors and that the BETTA wholesale price is, in fact, too low to cover long run generation costs. The BETTA model is thus not a sustainable long-term model.

Our analysis shows that firms in BETTA are not making losses due to the low wholesale price, as they are compensated by large retail margins. This favours incumbents with established customer bases and makes entry of new generators difficult.

We also estimate that the cost of supporting renewables per megawatt hour of electricity consumed is much higher in GB than in Ireland, even though renewables account for a smaller share of overall consumption.

In the SEM there has been extensive new entry resulting in significant construction of thermal generating plants without ad-hoc intervention by the regulatory authorities. In BETTA, on the other hand, there has been a dearth of new thermal plants coming on line. In fact special provision had to be made to ensure new investment in a nuclear plant at Hinkley Point to maintain sufficient capacity. To encourage new generating plants to come on board, incentives for investment in BETTA must grow, suggesting that the gap between SEM and BETTA wholesale prices will narrow in the future. Some form of remuneration for capacity seems inevitable. However, this does not imply that retail prices will have to increase in equal proportion. Our analysis indicates that total electricity prices in BETTA are sufficient (or close to being sufficient) to remunerate all aspects of providing electricity, but currently all the profits are extracted at the retail stage.

The GB market could (and should) be restructured to allow generators to be fairly remunerated for their costs while simultaneously decreasing retail margins to avoid overburdening final consumers. It is difficult to envisage how this can be achieved without changing a system that is currently based on vertically

⁴ Deane, P., J. FitzGerald, L. Malaguzzi Valeri, A. Tuohy and D. Walsh (2014). Irish and British electricity prices: what recent history implies for future prices, *Economics of Energy and Environmental Policy*, 3(2). Published online <http://www.iaee.org/en/publications/eeeparticle.aspx?id=67>

integrated firms, bilateral contracts and limited regulation. The example of the SEM shows that strong regulatory oversight can work well with appropriately structured liberalised markets.”

28. Some of the assertions about the SEM and about the quality of regulation and regulatory oversight in Ireland should be taken with a strong pinch of salt. (For example, the Irish energy regulatory body functions as a policy-implementing arm of government – and it implements formal and implicit policies, despite every effort being made to project the optical illusion that it is an agency functioning independently of government.) But the assertions about the British electricity market appear to dovetail with those in recent British assessments.